Purchase Agreement

Business Owner Action Item: Engage Hibiscus Legal to draft or review the purchase agreement.

Why is This Important? The purchase agreement is a binding legal contract that provides the terms and conditions of the sale. The business owner's rights and obligations will be defined in the purchase agreement.

This article will discuss the following key legal issues of a purchase agreement

1. Structure of an acquisition
2. Purchase price considerations
3. Representations and warranties
4. Types of representations and warranties in the purchase agreement
5. Exceptions to representations and warranties
6. Survival of representations and warranties
7. Covenants
8. Conditions precedent

Structure of an Acquisition

There are two basic forms to structure an acquisition: an asset purchase and a stock purchase.

1. Asset Purchase. The Buyer acquires all or selected assets of the Company and assumes all, some, or none of the liabilities of the Company via an asset purchase agreement.
    a. Advantages.
        i. The Buyer can acquire all or only selected assets and all or only selected liabilities.
        ii. The Buyer can avoid dealing with minority shareholders in most circumstances.
        iii. The liabilities of the Company, including any undisclosed liabilities, are not attributed to the Buyer (i.e., the Buyer does not assume such liabilities because the liabilities remain the obligation of the Company).

    b. Disadvantages.
        i. The corporate identity of the Company is not preserved for the Buyer.
        ii. More complex documentation requiring assignment and conveyance instruments (causing, in many instances, otherwise undisclosed problems to surface).
        iii. May require numerous consents to assignment of contractual rights, potentially causing delay and giving rise to additional costs.
        iv. May trigger acceleration of certain obligations and require prepayment of the Company's debt.
        v. If significant amount of real estate is involved, transfer taxes, recording fees, etc. may be substantial.

2. Stock Purchase. The Buyer purchases the stock of the Company directly from the Company's shareholders via a stock purchase agreement.

a. Advantages
    i. The Company's corporate identity is preserved together with licenses, permits and local qualifications to do business (other than those that may be affected by a change in control).
    ii. The Company's contract rights will not be impaired (other than those that may be affected by a change in control).
    iii. Relatively simple transaction when the Company is closely-held.
    iv. Simpler documentation because there is no need to transfer individual assets, rights, and liabilities.
b. Disadvantages
    i. The Buyer acquires the Company subject to all its liabilities, including any undisclosed liabilities.

<u>Purchase Price Considerations</u>

This section discuses four purchase price issues that a business owner should consider when selling the Company. Negotiating the purchase price involves more than simply agreeing on a number. Payment terms and tax implications can dramatically affect the amount of cash received. A business owner should understand the issues discussed in this article so he can negotiate effectively.

1. <u>Payment Terms</u>. The business owner should negotiate to receive as much cash at closing as possible. The Buyer will likely try to defer a portion of the purchase price through an earn-out, escrow, holdback, or promissory note (as discussed below). If the Buyer insists on deferring a portion of the purchase price, then insist on a higher purchase price to compensate for the delay in receiving your money.

2. <u>After-Tax Proceeds</u>. Focus on the after-tax proceeds that you will receive as opposed to the nominal purchase price. This requires planning and coordination with a tax professional to estimate the tax attributes prior to the sale. A stock sale is more advantageous to the business owner because the business owner will receive long-term capital gain treatment for the sale of the stock. Accordingly, the business owner is usually willing to receive a lower purchase price in a stock sale because the income tax liability is lower than an asset sale. An asset sale is more advantageous to the Buyer because the Buyer will receive a step-up in basis in the assets of the Company. The Buyer will then be entitled to depreciation deductions, which will lower the Buyer's effective income tax rate and cash tax liability. Accordingly, the Buyer is generally willing to pay a higher purchase price in an asset sale.

3. <u>Purchase Price Allocations</u>. If the sale is structure as an asset sale, then the purchase price must be allocated among the assets purchased for the purpose of determining the tax treatment. Some assets are taxed at long-term capital gains rates (e.g., goodwill) and some assets are taxed at ordinary income rates (e.g., equipment). The Buyer and the business owner agree to this allocation in the asset purchase agreement. The Buyer would prefer to allocate as much of the purchase price to equipment as possible because equipment is depreciated over 1 – 3 years (i.e., the Buyer is entitled to higher depreciation deductions). The business owner would prefer to allocate as little of the purchase price to equipment as

possible because equipment is taxed at ordinary tax rates. The Buyer would prefer to allocate as little of the purchase price to goodwill as possible because goodwill is depreciated over 15 years (i.e., the Buyer is entitled to smaller depreciation deduction). The Buyer would prefer to allocate as much of the purchase price to goodwill as possible because goodwill is taxed at long-term capital gains rates.

4. Escrow and Holdback. An escrow provision provides that a portion of the purchase price will be held in escrow by a third-party escrow agent for a certain period after the closing. Any claims made by the Buyer for indemnification under the purchase agreement will be paid from the amount held in escrow. A holdback provision is the same as an escrow provision, except that the funds are held by the Buyer instead of an independent escrow agent. The business owner should avoid escrow and holdback provisions because they delay receipt of the sales proceeds.

Representations and Warranties in the Purchase Agreement

Representations and warranties ("R&Ws") are the primary contractual mechanism to

1. Identify potential liability associated with the Company, and
2. Allocate risk between the Buyer and business owner.

R&Ws are statements of fact made in the purchase agreement by the Buyer to the business owner and the business owner to the Buyer at a particular point in time. R&Ws create a "snapshot" of facts that are important to the Buyer's and the business owner's decision to enter into the purchase agreement. If a party's R&W is not true, then the other party having indemnification rights (i.e., the right to recover damages) under the purchase agreement. The failure of a party's representations to be true will result in the other party having rights and remedies under the contract.

Imagine if the Buyer is buying a company in a licensed industry. The Buyer will want to know whether the Company is properly licensed with the State. The Buyer may have done due diligence providing a moderate degree of comfort that there are no licensing issues. However, it's possible there is a licensing issue that was not discovered in the due diligence. If, after the closing, the State's regulatory agency assesses penalties and fines to the Company, then the new owner will suffer the financial loss. This risk would be addressed by requiring the business owner to make a representation in the purchase agreement regarding compliance with State licensing laws and regulations. If the Buyer discovers before the closing that the representation is untrue, the Buyer will have the right to terminate the contract and walk away from the deal. Alternatively, if the licensing issue is discovered after the closing, the Buyer will have an indemnification claim against the business owner for breach of representation.

The purpose of negotiating representations is to discover factual issues that might not otherwise be disclosed. The problem is that parties are under no legal obligation to make any disclosure when negotiating a purchase agreement. A party counteracts this problem by requiring disclosure of facts that may be relevant to its decision to enter into the contract. This is accomplished through the other party's representations and warranties.

Going back to the example above, the Buyer will ask the business owner to make the following representation: Seller has all governmental or other permits, licenses, approvals, certificates of inspection, filings, franchises, and other authorizations that are necessary to operate and operate the Company and has not received notice alleging that any other governmental or other permits, licenses, approvals, certificates of inspection, filings, franchises, or other authorizations are required.

If the business owner refuses to make the representation, then the Buyer will conclude that the Company has licensing issues. The business owner could give the representation "to the best of its knowledge," so that the representation is breached only if the business owner fails to disclose relevant facts actually known to it. The business owner could also make a complete disclosure of all licensing issues in order to avoid liability. The disclosures may give rise to additional demands on the representing party, such as the Buyer may require the business owner to resolve any licensing issues before the closing or reduce the purchase price to compensate the Buyer for having to pay for the remediation itself. The Buyer may also walk away from the purchase agreement.

Representations allocate risk between parties to the purchase agreement. The party making a representation assumes the risk that if the representation is untrue, the other party will have a claim against it or some other remedy under the contract.

Types of Representations and Warranties in the Purchase Agreement

There are three categories of representations and warranties.

1. Enforceability Representations
    a. Enforceability representations provide assurances that the parties have the authority to enter into the purchase agreement.
    b. Enforceability representations ensure that a party cannot rescind the purchase agreement on a mere technicality (e.g., the signer did not have the authority to bind the party).
    c. A corporation or limited liability company cannot validly execute and deliver a purchase agreement unless
        i. it validly exists as a legal entity,
        ii. it has the legal power and authority to enter into the agreement, and
        iii. all necessary organizational action has been taken to authorize the entity's entering into the agreement.
    d. For example, an entity will represent that it has taken all necessary action to authorize the execution, deliver and performance of a purchase agreement.
        i. In the case of a corporation, this representation would be correct if the corporation's board of directors had duly adopted a resolution authorizing the corporation to enter into the agreement.
        ii. In the case of a limited liability company, this representation would be correct if the company's members had duly adopted a resolution authorizing the company to enter into the agreement.
2. Subject Matter Representations
    a. Subject Matter Representations provide assurances that the parties will receive exactly what was negotiated in the purchase agreement.

b. Subject Matter Representations are specific to the facts and circumstances of the purchase agreement.
c. For example, a purchase agreement will include representations by the business owner that the property to be transferred is not subject to any lien.

3. Due Diligence Representations
    a. Due Diligence Representations provide assurances that the parties will be able to perform their contractual obligations in the purchase agreement.
    b. A party entering into a purchase agreement will normally undertake due diligence, such as reviewing financial statements, patient lists, accounts receivables, etc.
    c. Due Diligence Representations counteract the principle of caveat emptor (a party is under no obligation to volunteer information that is not required to be disclosed).
    d. For example, a purchase agreement will include representations by the business owner that there are no actions, suits or proceedings pending against the dental practice.

Exceptions to Representations and Warranties

There are situations where a party cannot make a representation due to information that is inconsistent with the statements made in the representations. For example, a dental practice is in the process of litigating a malpractice claim during purchase. The business owner cannot make a representation that there are no actions, suits or proceedings pending against the dental practice. This information must be disclosed in the purchase agreement to make the representation true. The disclosure may be done by making an exception for the inconsistent facts in the text of the representation. For example, the business owner represents that there are no actions, suits or proceedings pending against the dental practice except for the litigation of the malpractice claim.

Survival of Representations and Warranties

A survival clause means that the recipient of a representation continues to have the benefit of that representation after the closing. For example, if three months after the closing date the Buyer discovers that a representation was false at the time when it was made, the Buyer will have an indemnification claim against the business owner.

Absent a survival clause, the Buyer may bring a claim for breach of business owner's representations and warranties until the statute of limitations expires. A statute of limitations is a law that limits the time in which a certain legal claim may be brought against another party. If a party fails to commence litigation within the applicable statute of limitations, then the claim is barred. The Utah statute of limitations for breach of a contract is six years. Absent a survival clause in the purchase agreement, a party may bring a claim for breach of representations and warranties within six years.

When negotiating the purchase agreement, the business owner will usually want to include a survival clause to shorten the statute of limitations to less than six years. A survival clause typically sets forth that the representations and warranties of the business owner "survive" the closing for one year. A survival clause effectively reduces the statute of limitations from six years to one year.

Covenants

A covenant is a legal promise. There are two types of covenants in a purchase agreement: affirmative and negative.

1. An affirmative covenant is a promise to do something. An affirmative covenant in a purchase agreement generally obligates a party to complete a specific action.

2. A negative covenant is a promise not to do something or not take specified action. A negative covenant in a purchase agreement generally prohibits a party from engaging in a specific action.

<u>Example – Negative Covenant</u>
The most common negative covenant in a purchase agreement is a non-compete covenant. The main objective of the Buyer is to transition into the Company without losing customers. If the business owner opens a competing business next door, then the Company will lose customers to the business owner's new business. The Buyer will want to ensure that the business owner does not interfere with the transition. This is accomplished through a non-compete covenant. A non-compete covenant is a promise between the Buyer and the business owner that the business owner will not open a competing business near the Company or engage in competition with the Company after the sale. A non-compete covenant is designed to protect the Buyer and the Company after the sale.

<u>Exceptions</u>
There are two types of covenant exceptions: carveouts and baskets.

1. A carveout creates a specific exception to the covenant. For example, a typical non-compete covenant is "the dentist shall not practice dentistry within ten miles of the dental practice." The carveout is "but the business owner will be permitted to practice dentistry part-time at non-profit dental clinic located nine miles from the dental practice."

2. A basket is an exception that creates the limited ability to deviate from the covenant by some specified amount (usually expressed in dollars). In the example above, the exception could be converted into a basket by allowing the business owner to practice dentistry within ten miles up to a certain revenue amount.

<u>Remedies</u>
A purchase agreement usually provides for specific remedies in the event of a breach of a covenant. The most common remedy is specific performance, which merely requires the covenant to be performed. The party seeking to enforce the covenant may ask a court to issue a judicial order, which is an order that requires the covenant to be performed. The second most common remedy is equitable relief, which is a monetary penalty (e.g., $100,000).

<u>Conditions Precedent</u>
A condition precedent is a condition (i.e., a promise) or event that must occur before the parties are obligated to perform. In a purchase agreement, a condition precedent is a promise or event that a party is obligated to perform before closing occurs.

For example, a common condition precedent in a purchase agreement is that the business owner is not required to transfer the assets unless the Buyer pays the purchase price, and the Buyer is not obligated to pay the purchase price unless the business owner transfers the assets.

Failure by one party to satisfy a condition precedent allows the other party to terminate the contract. Typically, the party that has the right to terminate the purchase agreement uses the condition precedent to leverage a more favorable purchase price or more favorable terms.

The conditions precedent section of a purchase agreement usually has the following language: "*The purchaser's obligation to purchase the Company shall be subject to the prior satisfaction of the following conditions precedent*:"

This will be followed by a list of all the conditions precedent required to close. The obligation of the purchaser to purchase the Company is subject to the prior satisfaction of each of the specified conditions. The business owner's failure to satisfy any of the conditions will give the purchaser the legal right to terminate the purchase agreement. Likewise, the obligation of the business owner to sell the Company is subject to the prior satisfaction of each of the specified conditions. The purchaser's failure to satisfy any of the conditions will give the business owner the legal right to terminate the purchase agreement. Purchase agreements usually require both parties to satisfy a set of conditions, so that either party is excused from performance in the event the other party fails to satisfy the conditions precedent.

Most purchase agreements generally have similar conditions precedent. A party with a high degree of bargaining power may negotiate the satisfaction of several conditions before it will close. Common conditions precedent include:

- No breach. Performance is not required if the other party has breached its covenants or representations and warranties in the contract.
- Certified organizational documents. Entities will often be required to deliver copies of their certificates of incorporation, operating agreements, or other organizational documents.
- Corporate action. Entities will often be required to provide evidence of shareholder or board action authorizing the execution, delivery, and performance of the purchase agreement.
- Third party consents. Both parties usually want all material consents from third parties before closing.